

## Message Text

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FM AMEMBASSY LONDON

TO SECSTATE WASHDC IMMEDIATE 7627

C O N F I D E N T I A L SECTION 01 OF 03 LONDON 19635

PASS TREASURY FOR LISLE WIDMAN AND DON SYVRUD FROM  
JIM AMMERMAN

E.O. 11652: GDS

TAGS: EFIN, UK

SUBJECT: THE OUTLOOK FOR THE U.K. ECONOMY IN 1976

REF: LONDON 16867; LONDON 15193

SUMMARY AND INTRODUCTION: THE RECESSION ARRIVED LATER IN THE U.K. THAN IN ITS TRADING PARTNERS. GNP IN THE THIRD QUARTER OF 1975 IS 5 PERCENT BELOW A YEAR EARLIER, BUT THE YEAR-ON-YEAR DROP WILL BE ABOUT 2 PERCENT, MASKED BY THE POOR FIRST QUARTER OF 1974. INDUSTRIAL PRODUCTION STOPPED FALLING IN AUGUST. THE SHARP DECLINE IN THE U.K. ECONOMY IS BOTTOMING OUT. WHAT IS CURRENTLY LACKING IS THE MOMENTUM TO BEGIN MEANINGFUL RECOVERY. IN THE NEAR TERM, MUCH WILL DEPEND ON (A) THE LEVEL OF RECOVERY IN OTHER INDUSTRIALIZED COUNTRIES, AND THE ABILITY OF THE U.K. TO TAKE ADVANTAGE OF INCREASED EXPORT POTENTIAL AND (B) WHETHER THE ABNORMALLY HIGH U.K. SAVINGS RATIO BEGINS TO DECLINE. THESE TWO VARIABLES AND INVENTORY MOVEMENTS WILL HAVE A MAJOR IMPACT ON THE LEVEL OF U.K. ECONOMIC PERFORMANCE IN 1976.

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1976 WILL BE YEAR OF SLOW GROWTH, WITH BETTER PERFOR-

MANCE IN THE SECOND HALF. YEAR-ON-YEAR, REAL GROWTH OF GDP WILL BE IN THE 1 TO 2 PERCENT RANGE. THERE IS STILL LITTLE HOPE FOR INVESTMENT LED GROWTH. THE OUTLOOK IS FOR A FURTHER DECLINE IN MANUFACTURING INVESTMENT. PROFITS REMAIN TOO LOW. AS THE ECONOMY BEGINS TO MOVE UPWARD AND INDUSTRIAL AND COMMERCIAL DEMAND FOR FINANCE PICKS UP, CONFLICTS MAY EMERGE IN THE FINANCING OF THE GOVERNMENT'S LARGE BUDGET DEFICIT.

PROGRESS HAS BEEN MADE IN CONTROLLING INFLATION AND MODERATING WAGE INCREASES. BETTER PERFORMANCE IS EXPECTED NEXT YEAR, BUT STILL POOR BY INTERNATIONAL STANDARDS. UNEMPLOYMENT HAS INCREASED SHARPLY, AND WILL CONTINUE TO RISE IN 1976. ALTHOUGH THE INCOMES POLICY APPEARS TO BE HOLDING REASONABLY WELL, IT WILL FACE STRAINS AS REAL PERSONAL DISPOSABLE INCOME CONTINUES TO FALL. SOME ADDITIONAL FLEXIBILITY WILL PROBABLY BE ADDED WHEN PHASE TWO IS INTRODUCED IN AUGUST. IF THE LATE WINTER-EARLY SPRING WAGE NEGOTIATIONS KEEP TO THE SIX-POUND LIMIT, THE CHANCELLOR MAY FEEL THAT HE HAS SCOPE FOR SOME MODEST REFLATIONARY MEASURES IN HIS SPRING BUDGET.

THE BALANCE OF PAYMENTS DEFICIT ON CURRENT ACCOUNT IN 1976, DESPITE INCREASED IMPORTS, WILL REMAIN AT ROUGHLY ITS PRESENT ANNUAL LEVEL OF 2 BILLION POUNDS, THE OFFSET BEING THE FIRST SIGNIFICANT INFLOW OF NORTH SEA OIL DURING 1976. STERLING, HOWEVER, WILL CONTINUE TO FALL, BUT NOT AS SHARPLY AS THIS YEAR. THE DEFICIT WILL BE FINANCED BY PRIVATE CAPITAL INFLOWS, INTERNATIONAL BORROWING FROM THE IMF AND, IF POSSIBLE, FROM BILATERAL LOANS FROM OPEC PRODUCERS. END SUMMARY.

1. DOMESTIC TRENDS. THIS IS AN UPDATE OF THE REFERENCED MESSAGES AND IS NOT INTENDED TO REPEAT THE STRUCTURAL ANALYSIS CONTAINED IN THEM WHICH REMAINS UP TO DATE. IT IS REASONABLY CERTAIN THAT THE U.K. RECESSION BOTTOMED OUT DURING THE THIRD QUARTER. RECENTLY AVAILABLE DATA ON GDP, INDUSTRIAL PRODUCTION, INVENTORIES AND CONSUMER EXPENDITURE ALL POINT TO THIS CONCLUSION. HOWEVER, THERE IS GREAT UNCERTAINTY REGARDING THE SHAPE OF THE EXPECTED RECOVERY. MUCH WILL DEPEND ON THE BEHAVIOR OF CONSUMER SPENDING, THE SECOND STAGE OF INCOMES POLICY NEXT AUGUST, CONFIDENTIAL

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POSSIBLE FISCAL MEASURES INCLUDED IN THE NEXT BUDGET AND THE PACE OF RECOVERY IN WORLD TRADE.

2. AGGREGATE DEMAND WILL CONTINUE WEAK DURING THE FIRST HALF OF 1976. CONSUMER EXPENDITURE WILL BE AFFECTED BY THE DECLINE IN REAL PERSONAL DISPOSABLE INCOME RESULTING FROM THE GROWING GAP BETWEEN RISING PRICES AND WAGES HELD BACK BY THE SIX-POUND LIMIT. THE REDUCTION IN CONSUMER

EXPENDITURE WILL DEPEND ON THE BEHAVIOR OF THE SAVINGS RATIO WHICH HAS REMAINED ABNORMALLY HIGH (13-14 PERCENT) DURING 1975. WITH UNEMPLOYMENT CONTINUING TO RISE AND INFLATION AT ANNUAL RATES OF ABOUT 20 PERCENT EARLY IN 1976, IT IS UNLIKELY THAT THE SAVINGS RATIO WILL BEGIN TO

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DECLINE BEFORE THE MIDDLE OF THE YEAR. AS A RESULT, CONSUMER EXPENDITURE WILL NOT GIVE MUCH IMPETUS TO AGGREGATE DEMAND UNTIL THE SECOND HALF OF 1976.

3. DESPITE A LARGE AND CONTINUING FLOW OF INVESTMENT INTO NORTH SEA OIL, GROSS FIXED INVESTMENT WILL NOT BE A BUOYANT CONTRIBUTOR TO AGGREGATE DEMAND OVER THE NEXT 12 MONTHS. WHILE INVESTMENT IN MANUFACTURING INDUSTRY WILL BE DOWN BY 12-13 PERCENT IN 1975, IT WILL NOT DECLINE AS SHARPLY IN 1976; A FURTHER DROP OF 5 TO 8 PERCENT SEEMS A REASONABLE ESTIMATE IN THE LIGHT OF SLUGGISH DEMAND, OVER CAPACITY, SOME IMPROVEMENT IN PROFITS (BUT FROM A LOW LEVEL) AND HEALTHIER NET CORPORATE LIQUIDITY. INVENTORY LIQUIDATION, MASSIVE IN 1975/II AND III, TOGETHER WITH DECLINING INVESTMENT, ARE LARGELY RESPONSIBLE FOR

THE IMPROVEMENT IN CORPORATE LIQUIDITY. INVENTORY LIQUIDATION WILL SLOW DURING THE FIRST HALF OF 1976 AS STOCK OUTPUT AND STOCK SALES RATIOS ARE REDUCED TO MORE ACCEPTABLE LEVELS. INVENTORY ACCUMULATION SHOULD BEGIN DURING THE SECOND HALF OF THE YEAR AS THE RECOVERY BECOMES SUSTAINED.

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4. SINCE THE INCOMES POLICY WAS ESTABLISHED LAST AUGUST, THE GOVERNMENT HAS STRESSED ITS INTENTION TO REDUCE THE RATE OF INCREASE IN PUBLIC EXPENDITURE. WHAT BREACHES HAVE OCCURRED ARE LARGELY DUE TO (A) THE UNFORESEEN SEVERITY OF THE RECESSION WHICH HAS INCREASED THE SIZE OF THE PUBLIC SECTOR BORROWING REQUIREMENT TO 11-1/2 - 12 BILLION POUNDS AND (B) TWO MINOR JOB CREATION PACKAGES IN SEPTEMBER AND DECEMBER. WE WILL TAKE THE CHANCELLOR'S WORD THAT NEXT YEAR'S BUDGET WILL STICK TO THE CUTS ANNOUNCED LAST APRIL AND THAT SPENDING WILL SHOW LITTLE INCREASE. HE MAY FEEL THAT HE CAN INTRODUCE SOME LARGELY COSMETIC TAX REDUCTIONS TO MILDLY STIMULATE CONSUMER EXPENDITURE DURING THE EARLY STAGES OF THE RECOVERY AND HELP CREATE BUSINESS CONFIDENCE AND INVENTORY BUILDING. HOWEVER, THE MAIN GOVERNMENT EFFORT IN THE COMING MONTHS WILL BE DIRECTED TOWARD SHAPING A MORE FLEXIBLE INCOMES POLICY FOR 1976-1977 TO SUCCEED THE SIX-POUND PROGRAM. COOPERATION FROM THE UNIONS WILL BE CRITICAL TO ITS SUCCESS.

5. THE NORM OF THE POLICY WILL BE BELOW THE 11-12 PERCENT IMPLICIT IN THE CURRENT PACKAGE. HIGH UNEMPLOYMENT (1.3 - 1.5 MILLION) IS LIKELY TO BE A MAJOR ELEMENT IN OBTAINING UNION ACQUIESCENCE. BARRING EXTERNAL SHOCKS, THIS KIND OF PHASE II SHOULD HELP ENSURE THAT THE RATE OF INFLATION IS SHARPLY REDUCED IN 1976. IN ADDITION, BY FURTHER REDUCING THE RELATIVE COST OF LABOR IT SHOULD ENABLE EMPLOYERS TO INCREASE HIRING AS THE UPTURN GATHERS MOMENTUM.

6. THE BALANCE OF PAYMENTS. THE OVERALL CURRENT ACCOUNT DEFICIT FOR 1975 WILL BE IN THE RANGE OF 1,800 - 1,850 MILLION POUNDS. THE SOMEWHAT BETTER PERFORMANCE THAN EARLIER ANTICIPATED RESULTS IN PART FROM A CONTINUED LOW LEVEL OF OIL IMPORTS (AT LEAST A MARGINAL REDUCTION COMPARED TO 1974); A CONTINUATION OF A FAIRLY BALANCED LEVEL OF TRADE IN NON-OIL GOODS; AND A BETTER-THAN-ANTICIPATED SURPLUS ON INVISIBLE TRADE. THE DEFICIT ON TRADE IN PETROLEUM AND RELATED PRODUCTS WAS SOMEWHAT HIGHER IN THE LAST THREE MONTHS COMPARED TO THE PREVIOUS THREE MONTHS. THIS RESULTED FROM A BUILD UP OF STOCKS IN SEPTEMBER AND OCTOBER IN ANTICIPATION OF THE HIGHER OIL PRICES

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AND THE WINTER MONTHS. CURRENT FIGURES INDICATE THAT OIL COMPANY STOCKS ARE AT ABOUT THEIR LEVELS OF LAST YEAR (ROUGHLY 90-95 DAYS SUPPLY) AND POWER STATION SUPPLIES ARE UP ABOUT 10 PERCENT COMPARED TO LAST YEAR. COMPARING THE PERIOD JANUARY TO SEPTEMBER 1975 AND 1974, DELIVERIES OF PETROLEUM PRODUCTS FOR INLAND CONSUMPTION ARE DOWN 11.4 PERCENT.

7. FOR 1976, IT IS ANTICIPATED THAT IMPORTS WILL SHOW SIGNS OF INCREASING IN THE FIRST HALF OF THE YEAR TO RE-BUILD INVENTORIES AND AS THE UPTURN BEGINS. THE CONTINUED DEVALUATION OF STERLING WILL CAUSE AN ADDITIONAL ADVERSE EFFECT BUT THIS SHOULD BE AT LEAST PARTIALLY OFFSET AS THE YEAR PROGRESSES AND THE DEMAND FOR EXPORTS IMPROVES. THIS IS EVIDENT IN THE LATEST TRADE FIGURES. FOR THE THREE MONTHS, SEPTEMBER TO NOVEMBER, COMPARED TO THE PREVIOUS THREE MONTH PERIOD, THE UNIT VALUE OF EXPORTS INCREASED 4 PERCENT WHILE THE UNIT VALUE OF IMPORTS ROSE 4.1/2 PERCENT. IN VOLUME TERMS, HOWEVER, EXPORTS HAVE RISEN 5 PERCENT COMPARED TO A 1-1/2 PERCENT INCREASE IN IMPORTS DURING THE PERIODS OF COMPARISON. THE EFFECT MAY

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BE SOME DETERIORATION IN THE CURRENT ACCOUNT IN THE FIRST HALF OF THE YEAR BUT A REVERSAL IN THE LATTER HALF.

8. INDEPENDENT PRIVATE SECTOR ASSESSMENTS FORESEE NORTH SEA OIL REDUCING THE VALUE OF IMPORTS IN 1976 BY ROUGHLY 700 MILLION POUNDS, SAY \$1.4 TO \$1.8 BILLION. FOR THE YEAR AS A WHOLE, THE OVERALL CURRENT ACCOUNT DEFICIT WILL AGAIN BE IN THE RANGE OF L.8 TO 2.0 BILLION POUND HOWEVER, IF RECOVERY COMES MORE QUICKLY THAN ANTICIPATED AND A STRINGENT PHASE II INCOMES POLICY IS NOT ADOPTED IN THE SUMMER OF NEXT YEAR, THE VOLUME DEMAND FOR IMPORTS COULD INCREASE MORE RAPIDLY THAN EXPECTED AND RESULT IN SOME DETERIORATION OVER THE 1975 DEFICIT.

9. THE DEFICIT IN 1975 WAS FINANCED LARGELY BY RUNNING DOWN RESERVES, EXTERNAL BORROWING BY THE OFFICIAL AND PUBLIC SECTOR, AND POSITIVE ERRORS AND OMISSIONS. EXTERNAL RESERVES NET FELL BY \$1.2 BILLION FROM \$6.8 BILLION IN DECEMBER 1974 TO \$5.6 BILLION IN NOVEMBER 1975, BUT THIS NET FIGURE INCLUDES THE PROCEEDS OF AN ADDITIONAL \$1.75 BILLION OFFICIAL AND PUBLIC BORROWING DURING THE YEAR. STERLING /DOLLAR RATE FELL FROM A LEVEL OF ROUGHLY \$2.40 IN THE CONFIDENTIAL

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FIRST QUARTER TO SLIGHTLY OVER \$2.00 IN THE FOURTH. THE TRADE WEIGHTED DEVALUATION WIDENED FROM 21.6 TO SLIGHTLY OVER 30 PERCENT.

10. THESE BASIC TRENDS WILL CONTINUE IN 1976, BUT LESS SHARPLY. STERLING WILL CONTINUE TO FALL AGAINST ITS MAJOR TRADING PARTNERS. BANKERS EXPECT THE STERLING/DOLLAR RATE TO BE BETWEEN \$1.80 TO \$1.90 BY THE END OF THE YEAR. THE TRADE WEIGHTED DEVALUATION WILL FALL TO THE 34 TO 36 PERCENT LEVEL SOME TIME IN THE SECOND HALF. IN PART, THE CURRENT DEFICIT WILL BE FINANCED BY THE \$2 BILLION IMF DRAWING. THE U.K. STILL HAS \$800 MILLION IN TWO TRANCHES FROM A PREVIOUSLY ARRANGED BILATERAL LOAN FROM IRAN: \$400 MILLION SCHEDULED TO BE TAKEN IN 1975, THE REMAINDER IN 1976. THE IRANIANS HAVE BEEN SLOW COMING UP WITH THE MONEY, THIS YEAR'S TRANCHE NOT YET RECEIVED. THE U.K. WILL ALSO ATTEMPT TO WORK OUT ADDITIONAL BILATERAL BORROWINGS, AND POSSIBLY ANOTHER MAJOR EUROCURRENCY ISSUE IF DOMESTIC ECONOMIC TRENDS CONTINUE TO IMPROVE. THERE WILL BE

A RELUCTANCE TO DRAW RESERVES BELOW THE \$5 BILLION LEVEL.  
CAPITAL INFLOWS ASSOCIATED WITH NORTH SEA DEVELOPMENT WILL  
ALSO CONTINUE TO PROVIDE ASSISTANCE.

11. FORECASTS BY RESPECTED RESEARCHERS IN  
THE PRIVATE SECTOR SHOW REAL GDP GROWTH IN 1976 OVER 1975  
FROM A RANGE OF ZERO GROWTH TO PLUS ONE POINT FOUR (1.4)  
PERCENT. THE INCREASE IN CONSUMER PRICES IS FROM TEN (10)  
TO SIXTEEN POINT FOUR (16.4) PERCENT. UNEMPLOYMENT IS  
GENERALLY EXPECTED TO INCREASE DURING THE YEAR, THEN GRAD-  
UALLY FALL, BUT AT YEAR-END 1976 WILL BE HIGHER AT 1.3 -  
1.5 MILLION UNEMPLOYED THAN IN DECEMBER 1975 (1.2 MIL-  
LION). CURRENT ACCOUNT FORECASTS FOR 1976 RANGE FROM A  
SLIGHT SURPLUS (166 MILLION POUNDS) TO A DEFICIT OF 2.5  
BILLION POUNDS.

12. OUR BEST ESTIMATE FOR THE 1975 AND 1976 OUTCOME IS  
AS FOLLOWS:

	1974	1975	1976
REAL GDP (OUTPUT)	-0.9	-1.7 TO -1.9	0.8 TO 1.7
(ANNUAL PERCENT CHANGE)			
INDUSTRIAL PRODUCTION	-3.1	-4.6 TO -5.0	3.0 TO 4.5

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(ANNUAL PERCENT CHANGE)

MANUFACTURING INVESTMENT	10.9	-12 TO -13	-5 TO -8
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(ANNUAL PERCENT CHANGE)

RETAIL PRICES	16.1	24.0 TO 24.5	15.0 TO 17.0
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(ANNUAL PERCENT CHANGE)

UNEMPLOYMENT (DEC.S.A.)	0.644	1.2	1.3 TO 1.5
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(NUMBER IN MILLIONS)

CURRENT ACCOUNT	-3.8	-1.8 TO -1.85	-1.8 TO -2.0
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(BILLIONS OF POUNDS)

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